Foreclosure Aid Hinges on Eligibility, How Many Are Helped

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Should the federal government bail out a homeowner who lied about her income, bought a house far bigger than she could afford and now, predictably, cannot make the payments?

What about someone with a terrible credit record who has repeatedly missed mortgage payments? Should the government agree to pay off the lender if that mortgage fails?

The Bush administration says no, which is one reason the White House opposes an ambitious Democratic plan to defuse the nation's housing crisis by sharply relaxing eligibility standards for federal mortgage insurance. Under the proposal, lenders would be encouraged to wipe out a portion of the debt on troubled loans in exchange for a promise that the government would pay off the mortgage if the borrower can't.

Democrats and some mortgage analysts predict the plan would save more than 1.5 million families from foreclosure, keeping them in their houses and helping to stabilize plunging home prices. But federal housing officials and other analysts are skeptical that the plan could help enough people to prop up the housing market. They say so many of the nation's approximately 3 million subprime borrowers are in such deep financial trouble -- or share so much blame for their predicament -- that only a few hundred thousand are likely to qualify even under relaxed standards.

"It's going to be extremely difficult to reach a large portion of these borrowers," said Meg Burns, director of Single Family Program Development for the Federal Housing Administration. "Unless you transfer the risk and cost to the federal government, then they cannot be helped."

The chief author of the Democratic proposal, House Financial Services Committee Chairman Barney Frank (D-Mass.), called his housing plan "experimental" and acknowledged that it's impossible to say how many homes ultimately could be saved.

"I told my staff, 'Don't say a million and a half. Let's just try to do the best we can,' " Frank said. "The more risk you take, then maybe the more good you can do. But it's a very inexact line. If you can help hundreds of thousands of families, I think that's a pretty good deal."

President Bush and key Republicans are strongly resistant, however, to helping people who have little hope of repaying or who willingly signed up for irresponsible loans.

"If we continue to refinance bad credit risks, we're just asking for another problem six months or a year from now," said Sen. Richard C. Shelby (Ala.), the senior Republican on the Senate Banking Committee, which is considering a similar proposal. "There's some people -- and I'm probably kin to some of them -- that maybe shouldn't have ever bought a house."

Whatever the numbers, the Frank plan is gaining momentum in Washington because it represents the best idea so far for dealing with a problem at the heart of the mortgage meltdown: homeowners who now owe the bank more than their homes are worth due to falling home prices. Ordinarily, a borrower who cannot make payments would sell or refinance. An estimated 8.8 million borrowers no longer have that option because proceeds from the sale or the new loan would fall short of paying off the old one.

The administration and Federal Reserve Chairman Ben S. Bernanke have urged banks to write down loans voluntarily, but reductions in principal remain rare. So, in late February, Frank suggested a far more aggressive role for the FHA, the government's mortgage insurance provider.

Under his plan, the FHA would be authorized to insure about $300 billion in new loans, nearly doubling its current portfolio. The new mortgage insurance would be offered on refinanced loans in which lenders have agreed to accept 85 percent of a home's current appraised value as payment in full. That could mean a substantial loss to the lender but probably a smaller loss than if the devalued house were sold at a foreclosure auction. It also would keep the borrower in the house with more affordable monthly payments and an equity stake in the property.

The idea has won support among Democratic leaders in the House and Senate, as well as both Democratic presidential candidates. Last week, the presumptive Republican nominee, Sen. John McCain (Ariz.), endorsed a more limited version of the same idea, as did the White House.

A major difference between the administration's plan and Frank's proposal is the type of people who would be eligible for help. Under its newly expanded FHA Secure program, the administration would relax its requirement that loans be current, offering help to people who miss two or three payments. But the program would be limited to borrowers with subprime adjustable-rate mortgages, which periodically reset to higher payments. Borrowers also would have to meet the FHA's other standards, including overall debt payments that do not exceed 43 percent of monthly income.

Frank's proposal would loosen those standards. A borrower with any kind of loan -- not just a subprime ARM -- would be eligible for help regardless of how many payments he or she had missed or how bad his or her credit history is. To target the truly desperate, the plan would require borrowers to have an existing debt load equal to at least 40 percent of income. Under the new mortgage, the debt load could go as high as 55 percent of income if the borrower demonstrates an ability to make payments for at least six months.

Mortgage holders could offer loans in bulk for FHA insurance. All the new loans would be grouped in a rescue fund kept separate from the healthier loans the FHA now insures. Democratic aides acknowledged that the foreclosure rate on the new loans is likely to exceed the current FHA foreclosure rate of 2.34 percent.

Federal housing officials said the new loans would be unacceptably risky, leaving taxpayers holding the deeds to thousands of devalued homes. They also say too few people with these loans would qualify for help under Frank's proposal to boost the slumping housing market.

According to a HUD analysis of Federal Reserve Board data on borrowers with subprime ARMs, 60 percent have debt-to-income ratios of more than 40 percent, meaning they would meet Frank's standard for distressed borrowers. But about 10 percent are speculators who bought investment properties rather than primary residences and therefore would not qualify.

More than a third have so-called liar loans that required little or no documentation of income -- a sign that the borrowers cannot afford their homes under any circumstances. Nearly 40 percent have very poor credit scores, raising doubts about their ability to make payments. More than half have refinanced their homes at least once, stripping out cash for other uses.

Democratic aides say Frank's plan would cover the cost of loan defaults by charging mortgage holders high fees; it would also create a federal oversight board to evaluate risk and make adjustments. While the loans would carry more risk, aides said Frank's plan would give the borrowers a reasonable chance to succeed.

"If you've got something that improves the situation and it's got no downside," Frank said, "why don't you do it?"

Analyses of the proposal by Lehman Brothers and Merrill Lynch support the view that as many as 2 million borrowers could qualify for help. A more detailed analysis by UBS set the number at about 463,000. Last week, a report on the housing crisis by the Congressional Budget Office estimated that plans such as Frank's would benefit "perhaps several hundred thousand borrowers . . . over the next few years."

"Many authors of these proposals fail to appreciate the difficulty of meeting the two key criteria everyone agrees upon. Namely, that (1) only 'good' homeowners should be helped . . . and (2) the plan must be broad enough to have a noticeable impact on the housing market," the UBS report said. "It will be hard to design a program that achieves both objectives."